Section Two: Additional Views

A. J. Mark McWatters and Professor Kenneth Troske

We concur with the issuance of the December report and offer the additional observations below. We appreciate the efforts the Panel staff made incorporating our suggestions offered during the drafting of the report.

The issue discussed in this month's report – foreclosures and the government's efforts to help keep families in their homes – remain quite contentious and fraught with strong feelings among people debating this issue. However, when considering the effectiveness of programs designed to mitigate foreclosures, it is important to keep in mind that one of our primary goals should be returning the economy to a place where it can begin to grow at a pace that helps everyone currently in distress.

Certainly all of us would like to return to a world where we have steadily rising housing prices, low unemployment rates, and an economy that is growing at 4 percent to 5 percent per year. However, this is not the world in which we currently live. Instead, we are in an economy where housing prices nationwide have fallen by 14 percent from their peak,[443] where prices in the largest metropolitan areas have fallen by almost one-third,[444] and annual existing home sales have plunged by over 40 percent.[445] Without a doubt, the housing market has been in disequilibrium for several years, even before the recent discoveries of problems with foreclosures. The important question is what are the best policies for helping the housing market return to stability? Because until we achieve stability in the housing market, the economy will continue to limp along at 1 percent to 2 percent growth per year and unemployment will remain unacceptably high.

One of the main problems with the housing market is that in 2005 and 2006 many people borrowed money to purchase houses, or took out home-equity loans, predicated on the belief that housing prices would continue rising. It is important to note that few of these borrowers were first-time home buyers. Instead these were people who had a mortgage and decided to refinance in order to extract some of the equity they had built up in their house to purchase other goods.

---

[443] Federal Housing Finance Agency, *U.S. and Census Division Monthly Purchase Only Index* (Instrument: USA, Seasonally Adjusted) (online at www.fhfa.gov/Default.aspx?Page=87) (accessed Dec. 10, 2010) (hereinafter "U.S. and Census Division Monthly Purchase Only Index").

[444] Standard and Poor's, *S&P/Case-Shiller Home Price Indices* (Instrument: Case-Shiller 20-City Composite Seasonally Adjusted, Frequency: Monthly) (online at www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----) (accessed Dec. 10, 2010) (hereinafter "S&P/Case-Shiller Home Price Indices").

[445] Data accessed through Bloomberg Data Service (Dec. 10, 2010).

As long as home values kept rising, homeowners and other investors could refinance these loans at lower rates based on the accumulation of equity. When housing prices started to decline in 2006, many of these people were left with mortgages where the amount they owed was less than the value of the home. The question is, what if anything should the government do to fix this problem?

As we point out in the report, the Administration's foreclosure mitigation programs – primarily HAMP – have failed to provide meaningful relief to distressed homeowners and, disappointingly, the Administration has inadvertently created a sense of false expectations among millions of homeowners who reasonably anticipated that they would have the opportunity to modify or refinance their troubled mortgage loans under HAMP. In our view, the primary reason for HAMP's lack of success lies in the confusing and illogical basis for the program. Under HAMP, the government pays lenders and borrowers to modify a mortgage only when the estimated value of the modified mortgage (estimated using a procedure specified by the government) exceeds the estimated value of the foreclosed loan (again estimated using government rules). In short, under HAMP, Treasury is planning on paying $30 billion to lenders and borrowers to do something that they should be willing to do without receiving any money from the government. The fact that a program which should be an unmitigated success – paying people money for nothing – has had such limited success should be a clue that the situation is far more complicated then it appears.

To begin with, the structure of HAMP indicates that it is likely to have only limited success. HAMP works by reducing the monthly mortgage payments of borrowers through a capitalization of arrearages, a term extension, forbearance, and/or a reduction of interest rates or principal for up to five years. Then the program ends and the interest rate will gradually rise to the prevailing rate in place at the time the modification was made. Given the structure of the program, it seems unlikely that borrowers, especially those with negative equity, will be able to keep their homes unless we see dramatic improvements in the housing market, which also seems unlikely. The median borrower in the program had monthly debt payments equal to 80 percent of their pre-tax income.[446] On an after-tax basis, even after all the modifications have been done, after making their new monthly mortgage payment and all the other payments to lenders, the typical HAMP participant has $444 per month left over for expenses such as food, clothing, and health care, so it is hard to imagine how any modification is going to be successful.[447] Additionally, instead of being directed at borrowers who are in trouble because of some sudden, unexpected occurrence, such as losing a job or having the value of their home fall below the balance of their mortgage, this program is primarily focused on borrowers who can't make their monthly payments even though they are currently employed and not under water. This despite evidence from researchers at the Federal Reserve Banks of Atlanta and Boston showing that

[446] Data provided by Treasury.

[447] *See* footnote 52 *supra*, for further discussion of after-tax debt-to-income ratios.

helping workers who have experienced temporary shocks is much more likely to result in those owners keeping their homes.[448]

There are also a myriad of details and rules that limit the ability and/or willingness of lenders to modify loans. For example, for loans in which there are multiple liens, if the first lien holder modifies the loan without reaching an agreement with the other lien holders, then the first lien holder might have to take a subordinated position to the other lien holders. Given that over 40 percent of current mortgages have two or more liens; this significantly increases the cost of modifying a mortgage.[449] In addition, since a lender must recognize losses once a loan is modified, for banks holding a large number of underwater mortgages, this has the potential to impose a significant financial strain on the institution, a strain they will try to avoid.

We are also troubled that HAMP itself may have exacerbated the mortgage loan delinquency and foreclosure problem by encouraging homeowners to refrain from remitting their monthly mortgage installments based upon the expectation that they would ultimately receive a favorable restructure or principal reduction subsidized by the taxpayers. The curious incentives offered by HAMP arguably converts the concept of home ownership into the economic equivalent of a "put option" – as long as a homeowner's residence continues to appreciate in value, the homeowner will not exercise the put option, but as soon as the residence falls in value, the homeowner will elect to exercise the put option and walk away – or threaten to walk away – if a favorable bailout is not offered.

We remain unconvinced that government-sponsored foreclosure mitigation programs are necessarily capable of lifting millions of American families out of their underwater home mortgage loans. From our perspective, the best foreclosure mitigation tool is a steady job at a fair wage and not a hodgepodge of government-subsidized programs that create and perpetuate moral hazard risks and all but establish the government as the implicit guarantor of distressed homeowners. In the end it appears that, for most participants, HAMP will only postpone the inevitable.

So, what would be the downside if all HAMP does is postpone foreclosures for a few years? Well, as one of us has pointed out in an earlier Panel report,[450] despite all the attention they have received, homeowners with unaffordable mortgages were not the only group hurt by the financial crisis. Millions of homeowners who didn't have mortgages or who had affordable mortgages saw the value of their home plummet, and this was devastating for those who were going to use the equity in their home to finance their retirement. Millions of others saw the value

[448] Federal Reserve Bank of Atlanta Working Paper, *supra* note 88.

[449] Amherst Securities Group LP, Amherst Mortgage Insight, *2nd Liens—How Important*, at 3 (Jan. 29, 2010).

[450] April 2010 Oversight Report, *supra* note 1, at 179-180 (from the additional views of J. Mark McWatters).

of their retirement savings decline significantly, and families lost substantial amounts in their children's college savings accounts. For all of these people, relief will only come once the economy starts growing again. That growth will only occur once the housing market has stabilized, and that stability will not develop until people move out of homes with mortgages they cannot afford and into housing they can afford. So to the extent that HAMP simply kicks the foreclosure can down the road, it ends up hurting all of the people who are desperate for the economy to start growing again so that their lives can return to normal.

HAMP carries a 100 percent subsidy rate according to the Congressional Budget Office (CBO).[451] This means that the U.S. government expects to recover *none* of the $30 billion of taxpayer-sourced TARP funds invested in HAMP. Since Treasury is charged with protecting the interests of the taxpayers who fund HAMP and the other TARP programs, we recommend that Treasury's foreclosure mitigation efforts be structured so as to incorporate an effective exit strategy by allowing Treasury to participate in any subsequent appreciation in the home equity of any mortgagor whose loan is modified under HAMP or any other taxpayer-subsidized program. An equity appreciation right – the functional equivalent of a warrant in a non-commercial transaction – will also mitigate the moral hazard risk of homeowners who may undertake risky loans in the future based on the assumption that the government will act as a backstop with no strings attached.

This analysis is in no way intended to diminish the financial hardship that many Americans are suffering as they attempt to modify or refinance their underwater home mortgage loans, and we fully acknowledge and empathize with the stress and economic uncertainty created from the bursting of the housing bubble. It is particularly frustrating – although not surprising – that many of the hardest hit housing markets are also suffering from seemingly intractable rates of unemployment and underemployment. We also recognize that there have been serious mistakes, and perhaps fraud, committed by servicers and lenders in the lending and foreclosure process, and any illegal activity on the part of banks needs to be fully prosecuted. In addition, we know that many homeowners are rightfully frustrated and angry over the treatment they have received by lenders and servicers once they begin to experience financial distress. As such, we encourage each mortgage loan and securitized debt investor and servicer to work with each of their borrowers in a good faith, transparent, and accountable manner to reach an economically reasonable resolution prior to pursuing foreclosure. In our view, foreclosure should serve as the exception to the rule that only follows from the transparent and objective failure of the parties to modify or refinance a troubled mortgage loan pursuant to market-based terms. It is regrettable that HAMP creates disincentives for investors and servicers as well as homeowners by rewarding their dilatory and inefficient behavior with the expectation of enhanced taxpayer-funded subsidies. Since any intermediate to long-term resolution of the housing crisis must reside substantially with the private sector lenders and investors who hold the mortgage notes and liens,

[451] CBO Report on the TARP – November 2010, *supra* note 113, at 7.

instead of spending an additional $30 billion on a government-sponsored foreclosure mitigation effort, we believe Treasury would be best served by strongly encouraging these participants to engage in good faith, market-based negotiations with their distressed borrowers. In our opinion, this is the best way to bring stability to the housing market so that the economy can start growing again.